

3. "The main costs associated with interconnection are for long-lived capacity. They therefore represent capital costs that are the sum of financing costs and loss in value of the capital goods over time. ...We consider capacity-based interconnection charges to be the optimal approach for interconnection between a sophisticated TO [Telecommunication Operator] and a sophisticated interconnector."⁵

The European Commission study's conclusions that telephone company incumbents will set interconnection prices too high without regulatory controls and that interconnection charges should be based on the incremental cost of capacity required by the interconnector are directly relevant to the development of competition in the United States. The principles developed in that study are designed to promote a dynamic and efficient telecommunication market and are applicable to the U.S. telecommunication market as well as the European telecommunication market.

This paper focuses on the importance of using capacity measures for interconnection rather than charges per minute of use. Specific conclusions with regard to the price structure for interconnection charges include:

- (1) Minutes of use interconnection charges would not be sustainable in a highly competitive market;
- (2) Minutes of use interconnection charges fail to attain efficiency and lead to incorrect investment signals;
- (3) Minutes of use interconnection charges have been used in the past as a convenient allocator for fully distributed cost under regulated monopoly, but are not appropriate for the emerging market structure of greater competition.

II. Competition and Interconnection Charges

We should expect to see "sender keep all" arrangements develop in a competitive communications market if either of two conditions are met:

- (1) Traffic flows are very roughly balanced among the companies so that each sees a clear benefit for its customers in both sending and receiving traffic from other companies; OR

⁵Ibid., p. 92, 94.

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- (2) The cost to a company of terminating traffic is low in relationship to the transactions costs of measuring and charging for traffic so that even with unbalanced traffic companies find the simple "sender keep all" approach superior to efforts to develop appropriate cost-based terminating charges.

In a competitive communications market, we should only expect to see interconnection charges when traffic is largely one way so that the receiving company is disadvantaged by "sender keep all" and when the costs of terminating traffic are substantial in relationship to the transactions cost of developing and collecting interconnection charges. Under those conditions, we should expect to see interconnection charges based on the cost of the capacity required to terminate traffic.

The most comprehensive public engineering study of the incremental cost of local telephone usage (and therefore of the cost of terminating telephone traffic for competitors) was done by the Incremental Cost Task Force with members from GTE, Pacific Bell, the California Public Utilities Commission, and the RAND Corporation.⁶ The Task Force had access to data for telephone companies in California and performed a detailed engineering cost study for various output measures of local telephone service. Individual components were priced based on 1988 prices and costs were computed for switch investment, switch maintenance, interoffice transport, and call attempt costs. All costs were computed for calls during the busiest hour of the year because the investment and associated expenses are related entirely to capacity cost. The Task Force computed the following usage costs for each hundred call seconds (CCS) during the busiest hour of the year for "average" and "larger urban" exchanges:

switch investment	\$5.00	- \$ 10.00 per year
switch maintenance	.20	- .50 per year
interoffice calling	.50	- .60 per year
Total	\$6.00	- \$11.00 per year

In addition, the task force computed a cost of \$.30 to \$.90 per year for each call attempt during the busiest hour of the year and estimated approximately 1.25 busy hour attempts per busy hour CCS.⁷

⁶Bridger M. Mitchell, Incremental Costs of Telephone Access and Local Use, (Santa Monica, CA: The Rand Corporation, 1990); reprinted in William Pollard, ed., Marginal Cost Techniques for Telephone Services: Symposium Proceedings Columbus, Ohio: National Regulatory Research Institute, 1991) (NRRI 91-6).

⁷Ibid., p. 249, 250.

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The task force found that all costs were related to the capacity of the facilities used and could best be expressed as costs per year for capacity, rather than as costs per minute or per call. Using reasonable assumptions regarding the distribution of traffic, the costs determined by the Incremental Cost Task Force translate into an average of approximately 0.2 cents per minute, but most of the minutes during a year impose no incremental cost on the local exchange because they occur at off peak times.

A simple but useful way of analyzing the competitive interconnection issues is to consider two separate communities, A and B.⁸ Each is served by a single telephone company, but entry and exit are easy ("contestable markets" in economic terms). The cost for each company of terminating traffic for the other is the cost of building a channel of adequate capacity for the peak terminating load between the two companies' switches. The size of the channel is a proxy for all of the capacity related costs in terminating traffic. As discussed above, if the traffic is reasonably balanced or if the costs of providing terminating service are low in relationship to transactions costs, it is likely that both companies will find it in their mutual interest to provide terminating service for the other and will provide it on a "sender keep all" basis without explicit terminating charges.

Consider the case in which terminating cost (the cost of the channel between A and B) is substantial and the terminating traffic is all one way from A to B. That is, customers of A wish to terminate traffic in B, but customers of B have no desire to terminate traffic in A. In that case, A will have to pay the cost of termination because B is not getting a reciprocal benefit. There are two ways to manage the termination:

- (1) A could build the channel to B if that were technically feasible.⁹ Then the cost of termination for A would be the capacity cost for the peak termination load.
- (2) B could build the channel to A (add necessary capacity to its local facilities) and charge A for using it.

If B offers a long term contract based on the cost of providing a given capacity, then the price structure will be similar to the cost structure that A would incur by building the capacity itself. Either ownership method would create an effective rental

⁸They are not necessarily physically distinct communities but are communities connected to particular communication networks.

⁹A simple channel would obviously be technically feasible, but the more realistic case in which terminating traffic requires an increase in capacity of B's switches, interoffice transport, and so forth might not be technically feasible.

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price per time unit based on the capacity of the channel without regard to the actual number of minutes passing through it. However, suppose that B builds the necessary capacity to A and then decides to cover the cost with a charge per minute. Assume that the price per minute is determined by dividing the annual cost of the channel by the forecast number of minutes, so that B just covers its total cost. The price per minute will be higher than the true cost for off-peak usage and lower than the true cost for on-peak usage. That price structure would not be sustainable in a contestable market because a new entrant that offered prices more closely aligned with cost would attract all of the off-peak traffic. As the incumbent loses the off-peak traffic, its average price will no longer cover its cost and it will be forced to raise prices for the remaining traffic. The only sustainable price structure will be a cost-based charge related to the capacity of the facilities used to provide terminating service.

The reason why only capacity based charges would be sustainable in a competitive market can be clarified by considering the competitive market for rental automobiles. The cost of providing rental automobiles is more closely related to the time the car is rented than to the number of miles driven. Consequently, most rental companies charge by the time rented (day, week, or month) rather than by the number of miles driven. Charging by time for rental automobiles corresponds to capacity charges for interconnection while charging by miles driven corresponds to charges per minute of use for interconnection.

Suppose one rental company decided that all drivers should pay for each mile driven and set its rates as a price per mile rather than a price per day. Before customers adjusted to the changed price structure, the company could receive the same revenue with either method by simply setting the price per mile equal to the previous price per day divided by the average number of miles per day. However, that price structure could not last in a competitive market. It would cause those who drive long distances per day to pay far more than those who drive short distances. Because the real costs are related to the time the car is rented rather than to the number of miles, another company would offer a flat rate with unlimited miles and attract all of the long distance drivers. The company charging per mile rates would be left with only those who drive very short distances and would no longer cover its cost with the initial rates. As it raised its rates per mile in order to covers its cost, it would lose additional customers and eventually it would be forced to impose a cost related time charge in order to stay in the competitive business. Similarly, a competitive communications company would be forced to impose a cost related capacity charge rather than a minutes of use charge in order to survive in a competitive communications market.

III. Monopoly and Interconnection Charges

If the company providing interconnection services has a monopoly, then interconnection charges per minute of use will be sustainable because there is no competitive pressure to price in accordance with cost. However, interconnection prices based on minutes of use will not lead to maximum efficiency. They will distort both consumer decisions and investment decisions because they provide the wrong price signals.

Minutes of use pricing has been used extensively in the monopoly telecommunication industry of the past. Pricing on a minutes of use basis was mandated in the federal access charge plan. The access charge plan created in preparation for the January 1, 1984 divestiture of AT&T created a rigid structure of the prices to be paid from interexchange carriers to local exchange carriers for originating and terminating interstate traffic. Particular categories of cost determined by prescribed cost allocation procedures were required to be recovered by dividing the cost category by the forecast number of minutes and charging interexchange carriers the resulting price per minute for the access element.¹⁰

Although the per minute access charges were sustainable because of the largely monopoly structure of the local exchange industry, they distorted both consumer and business decisions away from maximum efficiency. On the consumer side, the access charges made it expensive for long distance companies to serve off peak residential customers. Long distance companies paid the same rate per minute to local telephone companies for traffic terminated late at night as they paid for traffic terminated at the peak of the business day. Consequently, discounted consumer rate plans for night calls that were established prior to the implementation of access charges became unprofitable. Long distance companies were forced to raise their prices to night time residential callers because of the artificial access charge structure even though the night time calls (utilizing otherwise idle capacity) imposed practically no cost on either long distance or local exchange companies.

Prior to the implementation of the federal access charge plan, an interim plan for initial long distance competition imposed access charges on long distance providers based on capacity used. That plan provided incentives for carriers such as MCI and Sprint to aggressively develop their residential customer base because residential calls were

¹⁰The legal description of the access charge plan is found in Title 47 of the Code of Federal Regulations, Parts 36 (separations cost allocations) and 69 (computation of access charges). An account of the political and economic issues related to access charges is contained in Gerald Brock, Telecommunication Policy for the Information Age: From Monopoly to Competition (Cambridge, MA: Harvard University Press, 1994), chapters 10 and 11.

primarily off peak and imposed little or no cost on the companies. Once the access charge plan was implemented with its per minute charges for all traffic regardless of when it occurred, the companies found that business traffic was more profitable than residential traffic. The incentives created by the minutes of use access charges thus distorted business marketing and investment decisions away from the efficient path.

The pernicious efficiency and investment effects of minutes of use interconnection charges can be illustrated by considering a regulated monopoly automobile rental company. If it (or its regulator) decides that charges should be determined by the mileage driven rather than by the time the automobile is rented, the resulting rate structure will be sustainable and can be designed to allow the company to recover its total revenue requirement. However, consumers will have an incentive to rent many cars for occasional short mileage driving. If the company is required to provide rental cars at the established rate to all who request them, it will be forced to make large investments in underutilized capital. It will recoup the costs of the investment by imposing very high charges on the long distance drivers.

The monopoly rental company will report to its regulators that it is subsidizing short distance drivers who are being provided cars below cost. Both the company and its regulators will be concerned about any proposals for competition because competitors would "cream-skim" the profitable long distance drivers, leaving only the unprofitable short distance drivers to the regulated company and threatening its viability. However, the entire problem is simply that the price structure does not correspond to the cost structure. The distortions and regulatory problems could be solved by shifting to a time based rental structure that matched the structure of cost in that market. Similarly, minutes of use access or interconnection charges reduce efficiency, create wrong investment incentives, and increase the difficulty of moving toward a competitive communications industry.

IV. Conclusion

Several conclusions can be drawn from this analysis:

- (1) The interconnection of two communications networks provides a benefit to customers of both networks;
- (2) The commercial providers of competitive non-regulated Internet service have recognized the mutual benefits of interconnection by agreeing to interconnect on a "sender keep all" basis, terminating traffic originated by others in exchange for having their originating traffic terminated by others. This is a useful model for

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interconnection of competing local exchange networks;

- (3) Minutes of use interconnection charges would not be sustainable in a highly competitive market;
- (4) Minutes of use interconnection charges fail to attain maximum efficiency and lead to incorrect investment signals;
- (5) Minutes of use interconnection charges have been used in the past as a convenient allocator for fully distributed cost under regulated monopoly, but are not appropriate in the emerging market structure of greater competition;
- (6) In order to facilitate the transition to a competitive communications market, regulators should emulate the competitive market outcome by setting interconnection prices (if "sender keep all" is not acceptable) determined by the cost of providing the necessary capacity for terminating traffic.

Interconnection And Mutual Compensation With Partial Competition

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(Prepared for Comcast Corporation)

I. Introduction

This paper examines the economic characteristics of various interconnection compensation policies when there are different levels of market power among the participants. The conclusions of the analysis are:

- (1) If there are no regulatory controls on compensation for interconnection, the monopolist of part of the market can extend its monopoly power to the entire market;
- (2) A mutual compensation policy without limits on the level of rates does not limit market power;
- (3) The level of rates under a mutual compensation policy is unimportant if and only if the level of incoming and outgoing traffic is exactly balanced. Because traffic levels will rarely, if ever, be exactly balanced, the level of rates will be an important factor in the viability of competition;
- (4) A mutual compensation policy with prices limited to the cost of service is the theoretically correct compensation policy. Mutual compensation with prices limited to the cost of service prevents the monopolist of part of the market from extending its market power to potentially competitive sectors of the market;
- (5) Capacity charges rather than per minute charges allow attention to be focused on the cost of service at the peak load which is generally the real cost of service;
- (6) "Sender keep all" is an administratively simple mutual compensation scheme with zero prices for terminating service. It is an attractive approximation to the theoretically correct policy of cost based prices when the incremental cost of terminating service is low.

The issues of interconnection rights and the compensation to be paid for traffic exchanged among interconnected companies have played a crucial role in the development of competitive alternatives throughout the history of the telecommunication industry. Interconnection disputes began with the early efforts to expand market power in the mid-nineteenth century telegraph industry and have continued to the present.¹

¹A brief summary of FCC efforts to devise appropriate interconnection policies for customer premises equipment, long distance service, and international service is contained in the appendix to this paper. For a more complete account see generally Gerald Brock, The Telecommunications Industry: The Dynamics of Market

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Although the long history of interconnection controversies provides several models of possible solutions to interconnection issues, the problems have not all been solved. Past interconnection controversies have led to three different kinds of solutions:

- (1) The customer premises equipment (CPE) model of zero interconnection charges;
- (2) The long distance model of substantial one-way per minute interconnection charges;
- (3) The international model of two-way per minute interconnection charges.

The emerging local competition requires an interconnection policy that will allow the efficient development of a "network of networks" in which customers have access to any combination of private and multiple public communications networks. The interconnection rules to and from monopoly networks should not be dependent on technology and should apply to both wireline and wireless services. This problem is more complex than past ones because there are no clear stationary boundaries across which interconnection must occur and because there will be a need for interconnection among companies with different and changing degrees of market power.

Both the CPE interconnection rules and the long distance provider access charge rules were developed in a context in which competitors were seeking interconnection with a monopoly public network. The international model provides a closer analogy to the emerging competition in which there may not be a clearly defined monopoly public network. Traditionally, international service has been provided jointly by the national carriers with neither national carrier allowed to provide service directly into the other carrier's country. The international accounting rate and settlement rate system is a mutual compensation arrangement in which the level of payment is negotiated by the carrier pairs and that level of payment is generally used for traffic in either direction. Whatever level of payment is chosen for carrier A to compensate carrier B for terminating traffic received from A is generally the same level used for carrier B to compensate carrier A for terminating traffic received from B.

The mutual benefit and mutual compensation aspects of the international model make it **appealing** as a framework for interconnection of a wide variety of networks in the future. However, even the increasingly competitive future situation is likely to retain areas of monopoly power, and the international model has encountered difficulties in dealing with different levels of market power among the participants in the bargain.

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With the mutual compensation approach, the actual level of payments makes no difference so long as traffic is exactly balanced in both directions. For example, suppose carriers A and B each originate 100 minutes of traffic to be terminated by the other. If the compensation rate for termination is \$1, each pays the other \$100, while if the compensation rate is \$10, each pays the other \$1000. In either case the payments exactly cancel out.

If traffic is unbalanced, the compensation rate does matter. If the more competitive carrier originates more traffic than it terminates (as has been the typical pattern in international communications), then a high mutual compensation rate favors the monopolist. For example, suppose low prices in competitive market B cause companies to originate 100 minutes while high prices in monopolized market A cause companies to only originate 50 minutes. Then a compensation rate for termination of \$1 causes a net payment from B to A of \$50, while a compensation rate of \$10 causes a net payment from B to A of \$500. Evan Kwerel's analysis of the international market concluded that with a net traffic outflow toward the monopolist, the mutual compensation principle does not limit the monopolist's ability to extract profit from the more competitive partner: "When the net traffic flow is out of the U.S., as with international MTS, ... U.S. carriers are making net payments to the PTT. The PTT can extract the same total revenue from U.S. carriers regardless of the terms for dividing the accounting rate by demanding a sufficiently high accounting rate."²

Because lower prices for calls originating in the competitive U.S. market than for calls originating in the generally monopolized foreign markets have created a net traffic outflow from the U.S., compensation rates above cost have created an increasingly large balance of payments deficit. Net outflow from U.S. carriers to foreign carriers increased by a factor of 10 between 1980 and 1992, rising from \$347 million in 1980 to \$3,344 million in 1992.³ The rising balance of payments deficit due to compensation rates above cost has led to extensive consideration at the FCC and other U.S. government agencies of ways to attain the "objective of promoting lower, more economically efficient, cost-based international accounting rates and calling prices."⁴

²Evan Kwerel, "Promoting Competition Piecemeal in International Telecommunications," FCC, OPP Working Paper 13 (December 1984), p. 49.

³FCC, Industry Analysis Division, "Trends in Telephone Service," (May 1994), Table 31, p. 48.

⁴"In the Matter of Regulation of International Accounting Rates," CC Docket 90-337, 6 FCC Rcd. 3552 (1991) at 3552.

II. A Framework for Analyzing Interconnection Issues

Today's communications marketplace is a hybrid with market segments of robust competition (no barriers to entry) and market segments of little or no competition (extensive barriers to entry). The problem is to create an interconnection policy that will be feasible across a wide range of situations, including different cost situations, different technologies such as wired and wireless, and different degrees of market power. The interconnection arrangements should be flexible enough to meet changing circumstances rather than having the rigidity of the existing prescribed access charge structure.

The interconnection and compensation arrangements are critical for the development of competitive benefits when there are some market segments with market power and other market segments subject to potential competition. Assume that customers can be divided into two groups: a set A for which entry is very difficult and a set B for which entry is easy. The division of the customers into two classes creates four different types of traffic:

- (1) traffic among the customers in A, designated AA traffic.
- (2) traffic originating from a customer in A and terminating in a customer of B, designated AB traffic.
- (3) traffic originating from a customer in B and terminating in a customer of A, designated BA traffic.
- (4) traffic among the customers in set B, designated BB traffic.

The significance of interconnection policy depends upon the relative sizes of AB and BA traffic compared to AA and BB traffic. If, for example, A and B represent very different kinds of customers with no desire to communicate between the groups, then AB and BA would be very small and interconnection policy would be largely irrelevant. In that specialized case, there could be one system serving A customers and a completely separate system serving B customers with no loss in efficiency. However, in the more normal case, the division of customers between A and B is a function of geography and customer characteristics that do not affect their desire to communicate with each other. Thus AB and BA represent substantial streams of traffic and it is necessary to have interconnection among the systems in order to promote efficiency.

A second factor that affects the importance of interconnection policy is the existence of fixed costs per subscriber compared to costs per unit of traffic. If there are no fixed costs per subscriber (any number of subscribers can be served at the same total cost so long as the total traffic carried is the same), then interconnection policy is less important than when there are fixed costs per subscriber. With no fixed costs per subscriber, it may be efficient to serve the different traffic streams with different systems

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(one system for BB traffic and another for BA traffic, for example). With fixed costs per subscriber, the subscriber must choose the system that best fits that subscriber's needs. Limitations on AB and BA traffic may make a separate system for BB traffic infeasible with fixed costs per subscriber, but not with only usage costs.

The remainder of this paper examines some of the interconnection issues with a "toy model" consisting of a total universe of six subscribers who desire to communicate with each other. The simplified model allows explicit solutions to be worked out in a way that is more obvious than either more realistic simulation models or mathematical formulations. However, the results are quite general and not dependent upon the specific characteristics of the simple model presented.

Assume there are six individuals, designated 1 through 6. Each person i has a linear demand curve for communication with each of the other five individuals shown in Figure 1. Each person demands 3 calls per time period with each other person when the price is zero per call, 2 calls per time period when the price is \$1 per call, 1 call per time period when the price is \$2 per call, and at a price of \$3 per call is priced out of the market. If all six people are connected in a network, the total demand of person i for communication with the other five individuals is simply the sum of i 's demand for communication with each of the individuals as shown in Figure 2; person i has a demand for 10 calls per time period to the entire network at a price of \$1 per call because person i desires to make two calls to each of the other five people at that price.

Assume that the cost of providing each call is \$0.5 for each call originated and \$0.5 for each call terminated. Thus the usage cost per call is \$1 for each call carried entirely over one network and is \$.5 for each call originated or terminated on the network. There are no interconnection costs for multiple networks. That is, the real interconnection cost (but not necessarily the price) of interconnection is zero, though there is a real cost to the networks of terminating traffic provided by other networks.

With a cost of \$1 per complete call, the competitive price is \$1 yielding a quantity demanded of 2 per person-pair or of 10 calls per person to the other people on the network. The pure monopoly price is \$2 per complete call yielding a quantity demanded of 1 per person-pair or 5 calls per person to the other people on the network, as illustrated in Figures 1 and 2.⁵ The monopoly price of \$2 per call yields a monopoly profit of \$1 per person-pair, while the competitive price of \$1 per call is equal to the

⁵The person-pair inverse demand curve is $P = 3 - Q_{ij}$ where P is the price per call and Q_{ij} is the number of calls from person i to person j . The corresponding marginal revenue curve is $MR = 3 - 2Q_{ij}$. Using the monopoly profit maximizing condition of marginal revenue equals marginal cost when marginal cost equals 1 yields a quantity of 1 and corresponding price of 2 for each person pair.

FIGURE 1

One Person's Demand Curve for calls to one other person

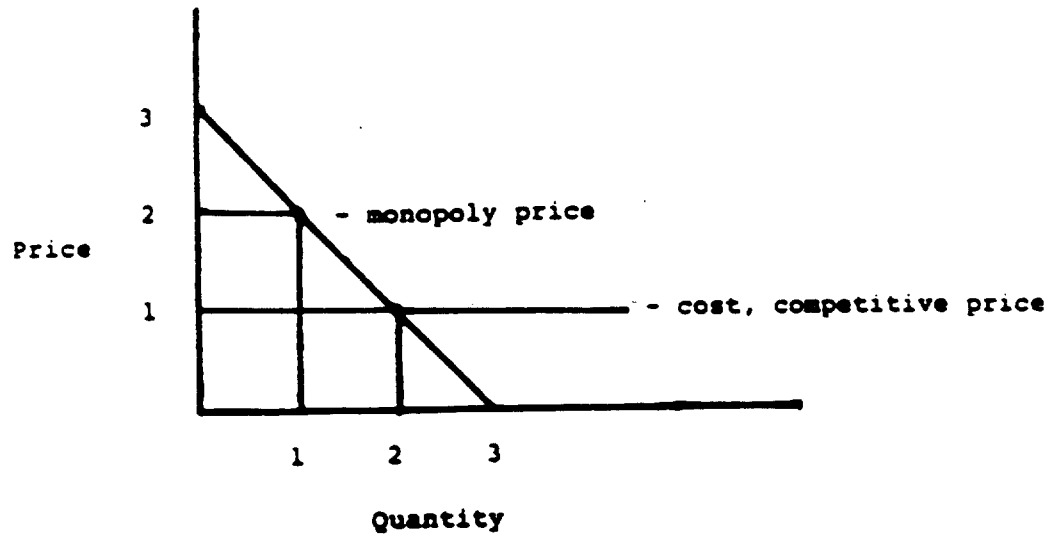
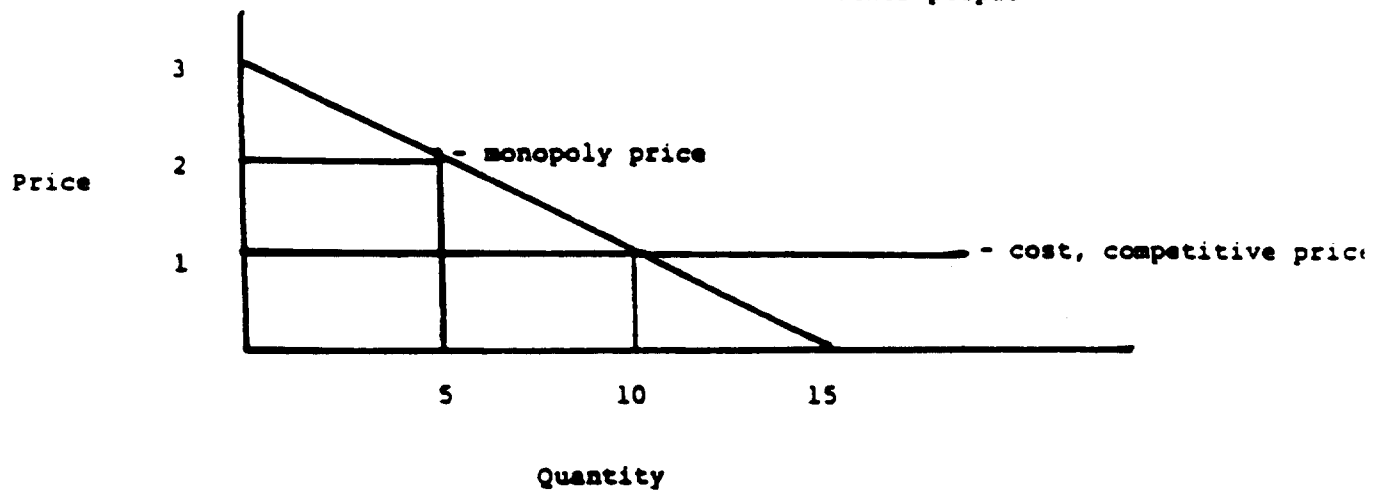


FIGURE 2

One Person's Demand Curve for calls to all five other people



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costs and yields no net economic profit. With no fixed costs per subscriber, the potential monopoly profit from the network is \$30 (6 subscribers each making one call per time period to 5 other subscribers and generating a monopoly profit of \$1 per call).

Assume that the incumbent is the only possible provider of service to the first three subscribers while anyone can serve the remaining three subscribers. That is, subscribers 1, 2, and 3 are in the set A of monopolized subscribers while subscribers 4, 5, and 6 are in the set B of competitive subscribers. There is no regulation of the prices that the monopolist can charge its own customers. In a standard market with no network externalities, these conditions would allow the monopolist of the A customers to extract monopoly profits from them, but would not allow the monopolist to extend its monopoly power to the B customers. The network nature of telephone service makes it possible for the monopolist to extend its power to the B customers through control of interconnection conditions. The best that an interconnection policy can do is to restrict the monopoly power to the set A. That is, a good interconnection policy will reduce potential monopoly profits from \$30 (the level at which all customers pay monopoly prices) to \$15 (the level at which A customers pay monopoly prices and B customers pay competitive prices). No interconnection policy in itself can reduce the monopoly power over A customers, but a poorly functioning interconnection policy can allow the monopoly to be extended to part or all of the calls from the potentially competitive B customers as well. The monopoly extension occurs because a poorly functioning interconnection policy limits the ability of carriers in B to terminate calls on A's monopoly network and may make competition in B infeasible.

The following examples assume for simplicity that only linear pricing (a specified charge per call) may be used, though the price may be different for different classes of customers. Allowing more complex pricing plans (such as multiple combinations of fixed and usage charges) would produce different numbers but would not yield different conclusions.

III. No Fixed Costs per Subscriber

With no fixed costs per subscriber, the monopolist of A sets a price of \$2 for AA calls (originating and terminating among customers of A), while the competitors that serve B set a price of \$1 (equal to cost) for BB calls. The interconnection conditions determine the prices for AB and BA calls.

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A. No Required Interconnection

If there is no interconnection requirement, A can monopolize the AB and the BA calls along with the AA calls, but cannot monopolize the BB calls in the absence of fixed costs. The monopolist of A can guarantee itself access to the customers of B either by purchasing access from a current supplier or by establishing its own affiliate to serve B. Competition in B means that no one can charge more than \$.50 (the cost of termination) for terminating calls from A; otherwise, another competitor would offer to do it more cheaply. A will maximize profits from its monopoly by charging a price of \$2.00 for AB calls (yielding a net profit of \$1 per call after paying its own expenses of \$.50 for originating and the competitive termination fee of \$.50), and charging an access fee of \$1.50 for BA calls. Because B is competitive and the cost of originating calls is \$.50, the B competitors will charge \$2.00 for BA calls, just equal to their total cost of \$.50 for origination and \$1.50 for termination.

Under these conditions, the equilibrium is full monopoly pricing of \$2.00 per call for AA, AB, and BA calls (each yielding a net profit above cost of \$1.00 per call) and competitive pricing of \$1.00 per call for BB calls (equal to the cost of service and thus yielding a net profit above cost of zero). The monopolist of A will make a profit of \$24 (\$1 each on the 24 total calls made at a price of \$2.00 for AA, AB, and BA calls). There will be 12 BB calls at a price of \$1.00 each, yielding a net profit of zero. If there had been a complete monopoly of both A and B, the potential profits in this situation would have been \$30 (including the \$24 realized profits and the \$6 unrealized profits that would have come from pricing BB calls at the monopoly level of \$2.00 each). The monopolist of half of the subscribers makes 80 percent of the total possible monopoly profits because of its control of interconnection conditions. In other words, bringing competition to half of the subscribers only reduced monopoly power by 20 percent.

B. Required interconnection with mutual compensation

In this situation, companies are required to provide interconnection with each other, and are required to charge and receive the same rate. That is, whatever one company charges for terminating calls must be the same rate it pays the other company for terminating calls. As in the first case, the monopolized AA calls will be charged at the pure monopoly rate of \$2.00 and the competitive BB calls charged at the cost-based rate of \$1.00 each. Now, however, the situation above in which A charges \$1.50 for terminating calls received from B and pays \$.50 to B for B's service in terminating calls received from A is disallowed because the rates must be the same.

While this case appears to reduce A's monopoly power, it generally does not affect it at all. Only in the very specialized case of exactly balanced traffic does mutual

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compensation without control of rates limit A's monopoly power. More generally, A can use its control of the actual compensation rate together with traffic imbalances to maintain its monopoly power. Because anyone can enter the service of B, the monopolist of A can establish an affiliate that serves B. The monopolist of A can then set a compensation rate that allows it to maximize profits in both the A and B market segments while making it infeasible for competitors in B to serve traffic from B to A. For example, the monopolist of A could set a compensation rate of \$2.00 for terminating any traffic received from A and also agree to pay \$2.00 for any traffic delivered either to its own affiliate or to other competitors in B. For a carrier in B that is not affiliated with the monopolist of A, the competitive price for traffic from B to A is then \$2.50 (\$.50 cost of originating the traffic plus \$2.00 paid to the monopolist of A for terminating the traffic). However, the affiliate of A will set a price of \$2.00 for B to A traffic because that is the profit maximizing price for the total company. The difference in pricing comes because the non-affiliated company sees the \$2.00 payment to the monopolist of A as a real cost that must be recovered in the price charged, whereas the affiliated company sees the \$2.00 payment as an internal company transfer that does not affect the real cost of doing business. For the affiliated company, the size of the payment affects which entity reports the profits, but it does not affect the total profit of the combined enterprise.

Because the affiliated company prices B to A traffic at \$2.00 while the non-affiliated companies price the same traffic at \$2.50, customers will choose the affiliated company. Once the affiliated company monopolizes the B to A traffic, it will naturally receive the A to B traffic as well. The profit maximizing solution for the monopolist of A and its affiliate in B is consequently to set a high compensation rate (any rate above \$1.50) and to price all traffic at the monopoly price of \$2.00, even though some of the traffic will show high profits and some will show losses if the specified compensation rates are taken into account. The total profits of the monopolist of A and its affiliate remain at \$24 or 80 percent of the total potential just as in the case of no required interconnection. Customers pay the same prices as in the case of no required interconnection. The requirement for mutual compensation has not reduced the monopoly power at all.

This case illustrates the problem with relying only on a structural solution such as mutual compensation without control of the actual rates paid. Consider, for example, the case of a local exchange company interconnecting with a wireless services provider. Assume that the local exchange company is the only service provider for some customers but that the wireless service can be provided on a competitive basis. If the local exchange company has a wireless affiliate, it can maximize the total profits of its enterprise by setting a high mutual compensation rate. Payments to the local exchange company from the wireless companies are an internal transfer for the affiliated company

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but a real cost for the unaffiliated company. So long as the competitive wireless companies send more traffic to the local exchange company than they receive from it (as is generally the case), then a high mutual compensation rate disadvantages the non-affiliated carriers and could make it impossible for them to compete with the affiliated carrier. Thus if the monopolist of part of the market is not restricted in its ability to enter potentially competitive sectors of the market, mutual compensation without control of rates fails to provide the consumer benefits of competition.

C. Mutual Compensation at Cost

In this case, each party must compensate the other at identical rates, but the rates are limited to the actual cost of providing terminating service. Using the model developed above, the compensation rate for termination service in this case would be \$.50 per call.

The competitors of B will provide BB traffic at the competitive price of \$1.00. They will also provide BA traffic at the competitive price of \$1.00, composed of \$.50 incurred as their own cost for originating traffic and \$.50 incurred as an access payment for terminating traffic. The monopolized customers of A will pay the monopoly price of \$2.00 per call for AA traffic and will pay the monopoly price of \$2.00 per call for AB traffic.

With cost-based interconnection charges, the opening up of 50 percent of the customers to potential competition reduces monopoly power by 50 percent. This contrasts with the case of mutual compensation without control of rates in which the monopoly power was only reduced by 20 percent. The cost-based interconnection effectively eliminates the network externality and makes the telephone network similar to a standard market. The two "products" of service to A and service to B can be sold separately in accordance with their respective market conditions. The cost based interconnection effectively severs the tie between the products, and removes it from the context of network externalities, vertical integration, or tightly complementary products.

The use of cost based interconnection also makes the monopoly power and actions of A very visible. In the preceding case, the customers of A and B were charged the same price, leaving some potential doubt as to whether A was truly exerting its monopoly power. In this case, the customers of A are charged twice the rate of the customers of B even for the same physical call and therefore the monopoly actions of A are clear.

IV. Fixed costs per subscriber

Assume a fixed cost of \$2 per subscriber. That is, any company that chooses to serve a particular subscriber incurs a cost of \$2 even with no traffic, and incurs the same costs as above (\$.50 originating and \$.50 terminating) for each call carried. Fixed costs per subscriber have been a standard part of telecommunication history, and many of the existing universal service provisions are concerned with defraying the fixed costs per subscriber. In telephone language, the previous section assumes non traffic sensitive (NTS) costs are zero and this section assumes NTS costs are significant.

A. No Required Interconnection

With no required interconnection, a company choosing to serve the potentially competitive customers in set B can only be certain of the BB traffic (the traffic among customers of B). A separate network to serve only BB calls at a price of \$1 per call as in the previous section is no longer viable because of the fixed cost per subscriber. A company desiring to serve only BB traffic must charge enough to pay the fixed cost of \$2 per subscriber as well as the usage cost of \$1 per call. The only way to do that with linear pricing is to charge the BB customers the monopoly usage price of \$2 per call, yielding a profit above usage costs of \$2 per person which is just enough to cover the fixed cost of serving the person. That provides no advantage to customers of BB compared to accepting service from the monopoly and therefore the separate network for BB customers alone is not feasible.

So long as interconnection is not required and the monopolist of A recognizes that service to BB alone is not viable, the monopolist of A will refuse connections. That allows A to monopolize the entire market. A's ability to extend its monopoly power from AA and AB traffic to include BA traffic in the case of no fixed costs now allows A to extend its market power to BB traffic as well.

Alternatively, A can accomplish the same thing as refusing to interconnect by setting a high fee for interconnection. If A charges \$1.50 for traffic terminating on its network, customers of B are indifferent between taking service from A or from B and A makes a profit of \$1 per call either directly from the customer or from the interconnection fees charged to B. The difference from the previous case is that A can now also make a profit of \$1 per call from BB calls because it is infeasible to pay the additional fixed cost of having a separate network only for BB calls. The combination of fixed costs and no interconnection requirements means that the potential competition for half of the customers does not reduce total monopoly power at all. The customers pay full monopoly prices for all calls, just as if there were no possibility of entry for any customers. Total potential monopoly profits are less in this case than before because of

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the fixed cost per subscriber. The potential monopoly profits of \$30 in the previous case are reduced by \$12 (fixed cost of \$2 per subscriber times 6 subscribers) to \$18. However, the monopolist of A now makes 100 percent of the potential monopoly profits rather than 80 percent as in the previous case.

B. Required interconnection with mutual compensation

A will demand a high rate (above \$1.50 per call) as a termination fee for any traffic received from B and will agree to pay the same rate for any traffic sent to a company serving B. However, A will also establish an affiliate in B and will send as much traffic as possible to its own affiliate. As in the case of no fixed cost, this transfers profit from the monopolist of A to A's affiliate serving B customers, but it does not reduce prices for customers or reduce total monopoly power. Because of the fixed costs per subscriber, no company independent of the monopolist of A will find it profitable to serve any part of the B market. The interconnection fee established by A makes it unprofitable to serve B customers without return traffic, and unaffiliated companies serving B cannot be certain of the amount of return traffic they will receive. The fact that unaffiliated companies see the interconnection fee as a real cost while the affiliated company only sees it as a transfer payment among parts of the company allows A to manipulate the fee to disadvantage its competitors. Thus even with half of the market open to competition and required interconnection with mutual compensation, A can monopolize the entire market by controlling the level of the interconnection fee.

As in the case of no fixed costs, the key issue in this case is that A is able to establish an affiliate to serve B, but competitors in B are not able to establish an affiliate to serve A. Consequently, A and its affiliate can pay any necessary fee to each other and recognize the profit in whichever place is convenient. So long as A can establish an affiliate in B, there is no difference between the case of required interconnection with mutual compensation and the case of no required interconnection. In both cases, the monopolist of A can entirely monopolize the market.

C. Mutual Compensation at Cost

With cost-based mutual compensation, the monopolist of A is no longer able to extend its monopoly power into the B market. As in the case of no fixed cost, cost-based mutual compensation allows the customers of BB and BA to enjoy competitive prices. The monopolist of A cannot artificially raise the price of BB or BA traffic by setting a high mutual compensation rate and transferring profits to an affiliate. Cost-based mutual compensation achieves the theoretical ideal of restricting monopoly power to the set of

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customers for which there are no alternatives and preventing the extension of monopoly power to potentially competitive markets through manipulation of interconnection compensation. With cost-based mutual interconnection, the opportunity for competition among half of the customers reduces total monopoly power in half. That contrasts with the case of mutual compensation without restrictions on the rate charged in which the opportunity for competition among half of the customers did not reduce monopoly power at all.

V. Practical Considerations in Designing an Interconnection Policy

Both existing policy toward international settlement rates and theoretical analysis support the goal of cost based compensation rates for jointly provided services. In the above examples, cost was a simple constant rate per minute. Unfortunately, the real world is not so simple and the actual definition and measurement of cost require care. For example, most telecommunication equipment is engineered for peak period usage. Because most of the cost of service is related to the capacity of the plant rather than the actual number of minutes used, the true cost for peak period usage is much greater than the cost for off peak usage. The cost of carrying off-peak traffic may be very near zero. Any interconnection policy should provide feasible administrative and measurement mechanisms and should provide maximum freedom for innovations in service and pricing. Two practical approaches to the general principle of cost based mutual compensation should be considered.

A. Sender keep all

A particularly simple approach to mutual compensation is sender keep all. Under this arrangement, each company is obligated to terminate traffic for other companies and is entitled to have its traffic terminated by other companies. Each company bills its customers for its originating traffic and pays no compensation to any other company for terminating service.

Sender keep all is mutual compensation with the price of terminating service set at zero. It is economically efficient so long as the real cost of providing terminating service is low. The incentives for manipulation are reversed in this case compared to the previous cases of above-cost terminating rates. Under sender keep all, each company has an incentive to increase the efficiency of its operations in order to reduce its costs and to maximize its outgoing traffic relative to its incoming traffic because outgoing traffic is the most profitable.

Although sender keep all departs from the theoretical goal of cost based compensation by setting a below cost price for terminating service, there is less

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opportunity for manipulation than with the price of terminating service above cost. If traffic is balanced, the price is irrelevant. Decreasing the incentives for traffic manipulation will tend to increase the balance of the traffic and reduce the significance of the difference between cost and the zero compensation rate. With mutual compensation rates above cost, the monopolist has an incentive to send as much traffic as possible to its own affiliate and as little traffic as possible to the competitors of its affiliate. With sender keep all, the monopolist has no incentive to send traffic to an affiliate. The monopolist does have an incentive to refuse to accept terminating traffic, but the interconnection requirement implies an obligation to terminate any traffic that is presented.

B. Peak Usage Measurement

The recent NYNEX-Teleport interconnection arrangement provides an example of a combination of usage charges and sender keep all arrangements. The general form of the agreement is to establish a particular charge for a two-way channel of given capacity between the two companies. Traffic is measured at the busy hour each month and the relative measurements are used as an allocation factor for the established channel rate. If traffic is exactly balanced, the payments to each company cancel out and the level of the established rate is irrelevant. If traffic is not balanced, and if Teleport, for example, sends more traffic to NYNEX than it receives from NYNEX at the busy hour, that imbalance is used to compute a net payment from Teleport to NYNEX.

The agreement is essentially a sender keep all arrangement for non-peak traffic. Because relative traffic is only measured at the peak hour, either company can increase its traffic to the other at non-peak times without affecting the charges due. For peak traffic, the agreement is essentially a per minute compensation scheme. An increase in peak period traffic from NYNEX to Teleport, for example, without a corresponding increase in the other direction, changes the financial flows between the companies in the same way that a per minute charge for peak terminating traffic would do.

The distinction between peak and off-peak traffic is beneficial for administrative simplicity and for economic efficiency. Costs are generally associated with peak traffic and therefore the effectively zero charge for terminating off-peak traffic is cost based.

While the structure of the NYNEX-Teleport agreement is beneficial for equating termination charges to cost during the off-peak period, it does not in itself solve the problem of increasing market power through high charges discussed in the previous sections. If the established price for a channel of given capacity is set far above cost, then the company with market power could engage in the same kind of manipulation discussed above. For example, with a very high priced channel, NYNEX could choose

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to not terminate traffic through Teleport during the peak hour while Teleport would have little choice but to terminate traffic through NYNEX. That could cause Teleport to pay rates for termination that were high enough to reduce the benefits of competition.

If the established price for a channel of given capacity is near the real cost, then the NYNEX-Teleport arrangement provides an attractive model for general interconnection issues. It would approach a cost-based interconnection fee for both peak and off peak traffic, leading to economic efficiency and opportunities for pricing innovations.

VI. Conclusion

When the market is composed of segments that are monopolized and segments subject to competition, interconnection and compensation arrangements are critical to the development of effective competition. A good interconnection policy will allow effective competition in the potentially competitive segments of the market while a poor interconnection policy will allow the monopolist of part of the market to extend its monopoly into potentially competitive sectors of the market. This paper has shown that the theoretically correct policy is mutual compensation at cost based rates and that mutual compensation alone is insufficient to limit monopoly power. A desirable interconnection policy should be closely related to the theoretically correct policy and also take account of the practical problems of administrative feasibility and of the definition and measurement of cost.

Several specific conclusions can be drawn from the analysis of this paper:

- (1) If there are no regulatory controls on compensation for interconnection, the monopolist of part of the market can extend its monopoly power to the entire market;
- (2) A mutual compensation policy without limits on the level of rates does not limit market power;
- (3) The level of rates under a mutual compensation policy is unimportant if and only if the level of incoming and outgoing traffic is exactly balanced. Because traffic levels will rarely, if ever, be exactly balanced, the level of rates will be an important factor in the viability of competition;
- (4) A mutual compensation policy with prices limited to the cost of service is the theoretically correct compensation policy. Mutual compensation with prices limited to the cost of service prevents the monopolist of part of the market from extending its market power to potentially competitive sectors of the market;

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- (5) Capacity charges rather than per minute charges allow attention to be focused on the cost of service at the peak load which is generally the real cost of service;
- (6) "Sender keep all" is an administratively simple mutual compensation scheme with zero prices for terminating service. It is an attractive approximation to the theoretically correct policy of cost based prices when the incremental cost of terminating service is low.

APPENDIX

Brief Summary of Past Interconnection Compensation Efforts

Interconnection issues have played a crucial role in competitive viability and in pricing policy throughout the history of the telecommunication industry. Interconnection disputes began with the early efforts to expand market power in the telegraph industry through limits on interconnection rights and continued through the Bell companies' early twentieth century denial of interconnection to independent telephone companies, the development of legal rights to interconnection, the private line and CPE interconnection controversies of the 1970's, and the development and implementation of the access charge system during the 1980's.

The 1980 Computer II decision to remove CPE from Title II regulation included the decision to eliminate the support flows that had previously gone from CPE to other parts of the industry. Customers gained the right to interconnect any amount of CPE (so long as it met specified technical standards) to the public network with no specific interconnection charge. Customers still had to pay the tariffed local rates for service, but CPE was "carved off" from the public network. That decision was made in the context of a monopoly public network and a potentially competitive CPE component. Without the interconnection requirements, the monopoly local network provider could also monopolize the CPE, but with the requirements, the CPE market could develop in a competitive way independently of the actions of the monopoly local network providers.

It would have been possible to apply the CPE model to long distance interconnection (allowing the competitors to interconnect at ordinary local rates as MCI originally requested in its Execunet service), but that would have eliminated the established system of revenue flows from long distance to local service. The decision first to allow AT&T to impose the ENFIA tariff rather than local rates for long distance interconnection, and then the development of the access charge system, implied a desire to maintain the system of revenue flows from long distance to local service. The access charge system together with the MFJ restrictions on BOC participation in long distance service allowed the long distance market to develop competitively without interference from the local exchange companies, but did not force prices to the true cost of service as normally happens in a competitive market.

Both the CPE and long distance controversies occurred in a market structure in which one party (the local exchange) was assumed to have monopoly power and the other party (the CPE user or long distance provider) was assumed to operate in a competitive market. Thus the policy concern was to ensure that the competitor could receive access to the monopolized market at an appropriate price. The international model provides

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a more equal example in which both parties are assumed to have market power. So long as AT&T was the only U.S. carrier for international telephone traffic, it could bargain over the compensation scheme with monopoly entities in foreign countries on an equal basis. However, the beginning of competition in the U.S. for international calls increased the bargaining power of the foreign carriers. The foreign carrier was no longer restricted to dealing with AT&T for U.S. traffic but could agree to send traffic to the U.S. carrier that offered the foreign monopoly carrier the most favorable terms. This possibility created considerable concern at the FCC over whether the beginning of international competition in the U.S. would only benefit foreign carriers and not U.S. customers. Evan Kwerel's 1984 analysis of the international market concluded:

This paper raises serious questions about the wisdom of deregulating U.S. international telecommunications without considering whether this will increase the market power of foreign telecommunications authorities. Increased competition among U.S. suppliers of international telecommunications services is likely to result in a reduction in the U.S.'s share of the benefits from such services unless the U.S. government takes appropriate countermeasures.⁶

The concerns raised in Kwerel's 1984 paper later developed into extensive FCC efforts to prevent monopoly foreign carriers from taking advantage of their unequal bargaining position with competitive U.S. carriers. The Commission found that equal payment in each direction was inadequate protection against manipulation for a monopolist of one side and sought to bring the rates paid for international terminating service down to the level of cost.

⁶Evan Kwerel, "Promoting Competition Piecemeal in International Telecommunications," FCC, OPP Working Paper 13 (December 1984), p. 49.